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2023 Annual Emerging Markets Equity Review

JANUARY 2024

Matt: Welcome everyone, and thank you for joining us for the annual investment review of the Dodge & Cox Emerging Markets Stock Fund. By way of introduction, my name is Matt Beck. I'm a Client Portfolio Manager and Vice President here at Dodge & Cox, and I'm thrilled today to be joined by my colleague Sophie Chen. Sophie is our Portfolio Director[1] for the Emerging Markets Stock Fund, she's also a member of our International Equity Investment Committee, as well as an Analyst really spearheading a lot of the work that we're doing in China and analyzing Chinese companies. Sophie, thanks so much for being here today.

Sophie: Thank you, Matt.

Matt: Before we get started, Sophie, maybe big picture, is there any type of lead-in, overarching takeaway that you'd like the folks on the call today to know about emerging markets before we dive into the deck itself?

Sophie: Yeah, I would say two points. One, we are very excited about emerging market investing. We think there are a lot of opportunities for both economic growth and capital markets growth, and many positive secular trends combined with low starting valuations. Second, looking at our portfolio today, we are seeing many interesting opportunities. We have a very diversified portfolio across regions, across sectors, across large-cap, well-known names, and smaller, less-known names that we are excited to share with you today.

Matt: Great, well I'm thrilled to talk about those as we go through the next 20 minutes or so. But maybe to start off and think kind of big picture on the market itself, one of the things that we know is that 2023 was a strong year for emerging market equities, and this is on slide five where we depict some of the features of the market during the year. Maybe take the audience through the market conditions in 2023. What was the environment that you and the team were operating in during the calendar year?

Sophie: Indeed, 2023 was a strong year for emerging markets. [The] MSCI EM (Emerging Markets) Index[2] was up 9.8%. We saw pretty strong post-COVID economic growth. We saw global supply chain normalization and also declining inflation in many parts of the world. So as you can see on the top-left chart, IT (Information Technology) and Energy are two of the stronger-performing industries. IT obviously helped by a strong enthusiasm in AI (artificial intelligence). Then from a regional perspective, we saw Latin America on the top-right chart on page five was one of the best-performing regions last year. Some of it was held by the strong FX (foreign exchange) in the region. And then on the other side of ledger, you saw China underperforming the [MSCI Emerging Markets] Index, and there was a lot of macro and geopolitical concerns around China.

Matt: One of the things that strikes me about these top two exhibits here on slide five is the dispersion that you're observing as the year went on. I imagine that that is something that intrigues the Investment Committee.

Sophie: Indeed. Volatility dispersion creates a lot of opportunities, so this is music to our ears.

Matt: Great. So moving on to slide six, this is a page which shows the performance of the Dodge & Cox Emerging Markets Stock Fund for a number of different time periods versus the MSCI Emerging Markets Index, which is our primary benchmark. So we've shown our performance here for the quarter ending December 31, for the full year 2023, and since inception. What we'll first observe is that the absolute performance for the quarter and the year was strong. We were slightly behind the benchmark for the fourth quarter, but well ahead of it for the one year. Since inception, the market has been more negative from an absolute perspective. This has been a time, especially towards the beginning of this run, that hasn't been as rosy for emerging markets. But we are pleased to say that we are in excess of the [MSCI] Emerging Markets Index since inception. That since inception number is since May 11, 2021, so we're thrilled to be moving towards our three-year anniversary this coming May 11, 2024.

Sophie: Yes, indeed.

Matt: As we move on to slide seven, we've looked at performance already, Sophie, but let's get into a little bit of the detail in what worked, what didn't during the year. We have attribution shown here, a number of sectors and their influence on performance, whether it be positive or negative. Obviously, you talked about music to our ears, we'd love to see a number of bars on the right side rather than left side, and that was the truth of 2023. But maybe if you wouldn't mind, take us through a few of these sectors and talk about some of the things that worked for the portfolio and maybe a couple of things that didn't work quite as well for us during the calendar year.

Sophie: The Financials [sector] is, as you can see on the top bar

Returns represent past performance and do not guarantee future results. Investment return and share price will fluctuate with market conditions, and investors may have a gain or loss when shares are sold. Fund performance changes over time and currently may be significantly lower than stated above. Performance is updated and published monthly. Current month-end performance can be obtained at dodgeandcox.com or call 800-621-3973.

here, the largest contributor to our performance last year. We have been finding a lot of interesting opportunities in emerging market Financials. As you know Matt, a lot of the markets have low credit and financial penetrations, and there are many private sector Financials that are gaining share against their public sector peers. So here, our Brazilian Financials, Itau [Unibanco] and XP, have done extremely well last year [and] were a contributor to our performance. Communication Services, you can see here, is also a big contributor to our performance. Here we have, for example, NetEase, a large gaming company in China that did very well.[3] And then on the other side of the bar, we can see Consumer Discretionary and Information Technology were detractors to performance last year. Here it was primarily due to our holdings in China e-commerce, so Alibaba and JD.com were detractors last year due to both the macro issues in China, but also some of their idiosyncratic situations [and] increasing industry competitive landscape. Then Samsung [Electronics] is a name that we underweight, which contributed to the [Fund's] underperformance in Information Technology.

Matt: Got it. One of the things that you and I have talked about in client meetings and in past discussions, such as this one that we're doing today, is that this Fund among the Dodge & Cox Funds is unique in that it has a number of larger positions. You've alluded to some of those positions in your description of the attribution on slide seven. But also, we have a number of smaller positions in this portfolio, which don't always get the headlines on an individual basis. But I'd love for you to talk to us a little bit about how those smaller positions have influenced performance.

Sophie: Yes. So to give some context, we have roughly half of the portfolio in about 200 names, each of which are less than 50 basis points[4] (bps), and the majority of those are in SMID-cap, so small- and medium-cap stocks.[5] In these stocks, we feel there are great opportunities to find interesting ideas because there's very little sell-side coverage. A lot of names are not well known outside the region that they operate in, and we do see a lot of potential for alpha[6] generation. So if we see the top performers or top contributors, we typically don't see any of these smaller names, but in aggregate they have been a consistent contributor to the Fund's performance. In fact, since inception, cumulatively these smaller positions have contributed to 11.5% [percentage points] of outperformance.

Matt: Super, let's move on to slide eight. Here we have a chance to really dig into the portfolio, and I know that the folks that are joining our discussion today are really eager to know what you and the team have been up to during 2023, so this is a way we can talk to you about that. Let me orient the audience to how this slide is constructed. At the very top, what we're showing is the GICS (Global Industry Classification Standard) sectors, which are pretty much universally used. You can see our allocation to each of those sectors—those are the brown bars—as well as the [MSCI Emerging Markets] Index's weight in each of those sectors—that's the light blue. At the lower left, we've shown our portfolio versus the Index in a variety of mostly risk or valuation metrics. In the lower center of page eight, we have shown our country allocation versus that of the Index, and then we've shown our ten largest holdings at the right. Maybe to whet the audience's appetite a little bit in terms of what you've been doing, would you mind Sophie, talking to us about some of the names that you've been adding during 2023? And maybe if you don't mind, take us through a couple larger names and a smaller name or two as well.

Sophie: Great, yes. So Financials is an area where we were pretty active last year. In addition to a number of holdings in Brazil and India that we've held, we've added two larger names. So HDFC Bank is the largest India private sector bank with a very strong track record of risk management—we added to that position in the latter part of 2023. Then Shinhan Bank, that's a leading [South] Korean bank with a very strong balance sheet and potential for significant capital return as we're seeing changes in the regulatory environment. And then on some of the smaller names, a small bank that we added last year was the Saudi Awwal Bank. That is a leading bank in Saudi Arabia that we also added in the fourth quarter of 2023. Other things we've done, as you can see, Information Technology is a sector that we are underweight the Index, but here we've actually reduced that underweight by adding pretty substantially to TSMC (Taiwan Semiconductor Manufacturing Co.). We can see on the bottom-right table, TSMC is now our largest position in the Fund—that's the Taiwan-based semiconductor fab (fabrication) company. And then on the Consumer Discretionary side, a lot of that is our China Internet names, and we've tried to diversify our holdings in China.

Matt: Great, thanks so much, Sophie. Let's zoom in a little bit on Financials because we've seen a page or two ago that it was the leading positive influence on performance during 2023. You alluded to some of the characteristics of the companies that we've been adding, that they are taking market share, growing at superior rates. You and I have also had discussions quite recently about the arc of interest rates in various emerging markets countries that they were almost ahead of our developed market peers in raising rates and now are almost in hold or even a drop state or environment, especially in a place like Brazil that you and I have discussed. Talk to us about how the Committee weighs some of the growth characteristics, governance characteristics, management characteristics that you've alluded to, qualities of these companies, but also overlays rate concerns that you might have in individual countries.

Sophie: First of all, I would say we are bottom-up investors focused on the company fundamentals and try not to make our investment decisions solely based on our prediction on the interest rates. So we try to own franchises that can be resilient through cycles. [To] the point about declining rates across markets, I think we should also recognize there's a wide dispersion of rates in emerging markets, you have countries like Turkey and Argentina that are still seeing very, very high inflation rates. And then for most of the emerging markets, we have indeed been seeing declining inflation, and therefore, declining interest rates. So the impact on interest rates to our Financials holdings are quite nuanced because a declining interest rate is not helpful for NIM (net interest margin[7]), but it's typically in an expanding monetary policy, therefore helping with the broader economic growth and that can bring down credit costs and [be] helpful for loan growth. So many factors are in place, and that's where we think our bottom-up fundamental analysis really helps us to find the best opportunities across different markets.

Matt: Terrific. What are the shorter or long-term thoughts of the Committee in China? Where are you finding opportunities? What's just the overall thinking there?

Sophie: China is one of the few major markets that actually declined last year, and we've all seen many negative headlines on China from the newspapers. I would say the punchline here is that despite all the concerns around China's macro situation [and] around the geopolitical uncertainty. We do not think that China is uninvestable. To wind the clock back, exactly this time last year, a lot of investors were quite enthusiastic about China on the reopening outlook. Today, as many investors are throwing their towels in and think China is uninvestablee think this could be an area where you want to be greedy when others are fearful. So what happened last year was the early hopes of COVID recovery did fizzle pretty fast. As the year went on, we saw the economic growth was pretty weak. We saw very high unemployment rates, [and] property, which is the troubled sector, saw a huge decline in sales. Frankly, the business and the consumer sentiment were pretty weak. In fact, we saw the first decline in FDI (foreign direct investment[8]) into China, a negative number since the number has been recorded. So we do recognize a lot of risks, but our framework has continued to be the same, which is evaluating all these risks against many of the fundamental factors and looking at the range of potential outcomes over the next three to five years. And here we are seeing opportunities, a number of opportunities. Many franchises we own are trading at extraordinarily cheap valuations, so we are pretty excited about that. Then on the portfolio context, we look at our total China exposure. As you can see on the middle table here, China is about 24% of the portfolio compared to MSCI EM (Emerging Markets) at 26.5%.[9] And then if we add Hong Kong and Macau, our total greater China exposure is pretty much in line with the market, so we are very cognizant of managing that total exposure.

Matt: Sophie, to finish up, we've talked a little bit today about how successful emerging markets were from an absolute perspective in 2023. However, we do need to acknowledge that emerging markets equities did trail developed market equities during the year from a performance perspective, they did trail U.S. equities from a performance perspective. So, maybe share with the folks that are on the call today, why do we continue to be constructive and enthusiastic about emerging market equities over the long term?

Sophie: Yeah, circling back to my comments at the beginning of this discussion, we are very excited about investing in emerging markets, both from a growth perspective and a valuation perspective. As you know, Matt, 80% of the global population live in the emerging markets and emerging markets contribute to close to 80% of global GDP (gross domestic product) growth. And there are many structural long-term positive trends such as demographics, urbanization, and advances in education and technology that we think will continue to play out in emerging markets. Then from a valuation perspective, the MSCI EM [Emerging Markets] Index was trading at 11.7 times [forward earnings[10]] at the end of 2023, and [when we] compare that to the S&P 500 [Index[11]] trading at 20.4 times, we think it is very attractive. We understand, of course, you can't translate economic growth directly into equity market returns. So here we think our strong process doing bottom-up fundamental research, looking out over the next three to five years, and also having a very strong value and price discipline can really help us ride through the volatilities in emerging markets.

Matt: Thank you, Sophie. I've really enjoyed our discussion today. And thank you to all of you that have joined us today. Happy New Year and the best for 2024, and thank you for your interest and continued confidence in Dodge & Cox.

Dodge & Cox Emerging Markets Stock Fund SEC Standardized Average Annual Total Returns as of December 31, 2023: 1 Year 13.37%, Since Inception (May 2021) -5.15%. Fund and Index standardized performance is available on our website.

Emerging Markets Stock Fund's Ten Largest Positions (as of December 31, 2023): Taiwan Semiconductor Manufacturing Co., Ltd. (6.3% of the Fund), Alibaba Group Holding, Ltd. (4.2%), Itau Unibanco Holding SA (3.3%), Prosus NV (3.0%), Axis Bank, Ltd. (2.8%), Samsung Electronics Co., Ltd. (2.3%), Glencore PLC (2.1%), Credicorp, Ltd. (2.0%), Anheuser-Busch InBev SA/NV (2.0%), and Teck Resources, Ltd. (1.9%).

1. The Emerging Markets Equity Investment Committee (five members with an average tenure of 17 years at Dodge & Cox) manages the Dodge & Cox Emerging Markets Stock Fund. We established the Portfolio Director role several years ago to serve in an organizational capacity. As the Portfolio Director, Sophie Chen sets the Investment Committee's meeting schedule, works with the analysts presenting at meetings to help them prepare for the Committee's review of specific advocacies, and moderates each meeting.
2. The MSCI Emerging Markets Index captures large- and mid-cap representation across emerging market countries.
3. The use of specific examples does not imply that they are more or less attractive investments than the portfolio's other holdings.
4. One basis point is equal to 1/100th of 1%.
5. "SMID-cap" comprise small- and mid-capitalization companies. Market capitalization is a measure of the security's size. It is the market price of a security multiplied by the number of shares outstanding.
6. Alpha is a measure of performance and indicates whether an investment has outperformed the market return or other benchmark over some period. Positive alpha means that the investment's return was above that of the benchmark.
7. Net interest margin (NIM) is a measurement comparing the net interest income a financial firm generates from credit products like loans and mortgages, with the outgoing interest it pays holders of savings accounts and certificates of deposit (CDs).
8. Foreign direct investment (FDI) is the direct investment by companies or governments into foreign firms or projects.
9. Unless otherwise specified, all weightings and characteristics are as of December 31, 2023.
10. Price-to-earnings (forward) ratios are calculated using 12-month forward earnings estimates from third-party sources as of the reporting period. Estimates reflect a consensus of sell-side analyst estimates, which may lag as market conditions change.
11. The S&P 500 Index is a market capitalization-weighted index of 500 large-capitalization stocks commonly used to represent the U.S. equity market.

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